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THE FINANCIAL SYSTEMS OF FINANCIALLY LESS DEVELOPED ASIAN ECONOMIES: KEY FEATURES AND REFORM PRIORITIES

*Aaron Batten, Poullang Doung, Enerelt Enkhbold, Gemma Estrada, Jan Hansen,
George Luarsabishvili, Md. Goland Mortaza, and Donghyun Park*

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WORKING PAPER SERIES**

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Aaron Batten, Poullang Doung, Enerelt Enkhbold, Gemma Estrada, Jan Hansen, George Luarsabishvili, Md. Golam Mortaza, and Donghyun Park

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ABSTRACT

Developing Asia's financial depth as a whole compares favorably with other parts of the developing world, but there are wide variations across subregions and economies. This paper examines the key features and reform priorities of the financial systems in Bangladesh, Cambodia, Georgia, Mongolia, and Papua New Guinea. All are low-income and lower-middle-income economies that have relatively underdeveloped systems heavily dominated by banks and with low levels of access, especially for the poor. The urgent priority for bank-dominated economies is creating a more competitive environment that mobilizes domestic savings, lowers the cost of capital, improves access, and channels credit to the most productive sectors. Reforming state-owned or state-linked banks can also yield sizable efficiency gains. A common need in all five is good governance in financial institutions and markets. Financial regulators in these countries face a difficult trade-off between promoting economic growth and safeguarding financial stability.

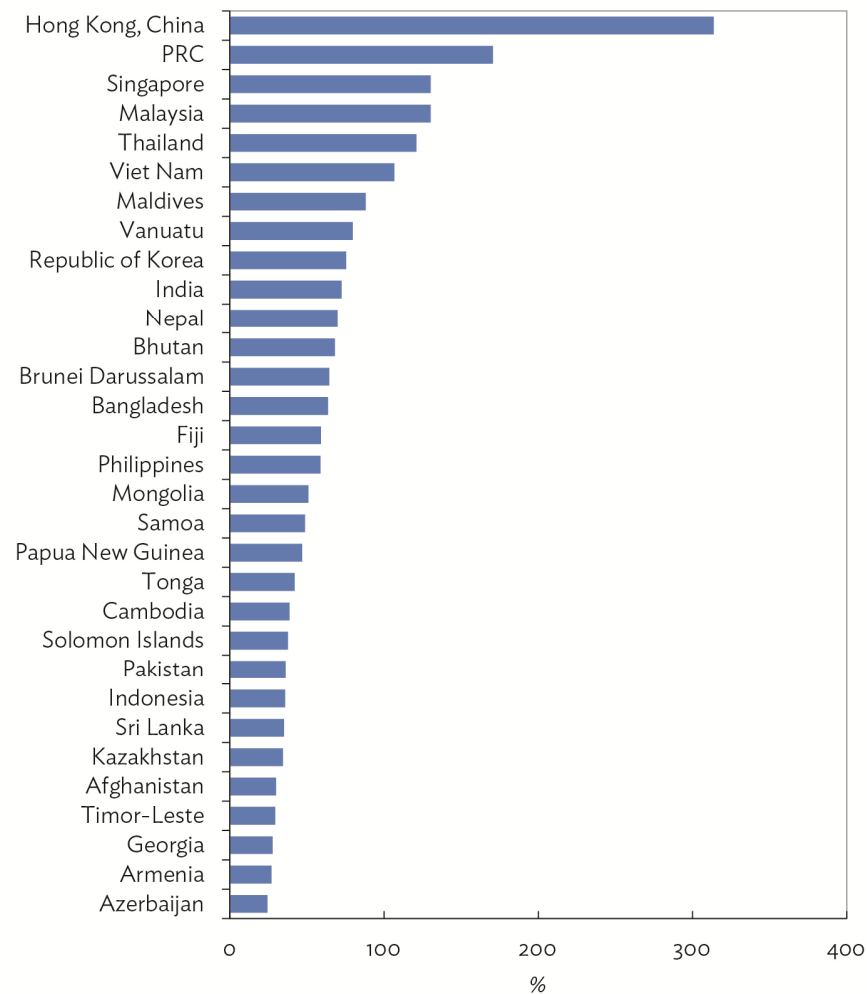
Keywords: financial development, financial system, low-income economies, lower-middle-income economies

JEL Classification: G20, G28

I. INTRODUCTION

Developing Asia's financial depth as a whole compares favorably with other parts of the developing world, although it still lags the advanced economies. The relative size of its banking sector and capital markets is larger than in Latin America, Africa, and elsewhere. Significantly, however, the high aggregate level of development masks wide variations across subregions and economies. East Asia, Southeast Asia, and South Asia have well-developed finance sectors while those of Central Asia and the Pacific are less developed. The variation is even greater among countries as is evident in Figure 1 which shows the ratio of liquid liabilities—currency plus checking and interest-bearing accounts in financial institutions—to gross domestic product (GDP), a widely used indicator of financial development. Broadly speaking, there are two groups of economies in developing Asia's financial landscape. Upper-middle-income economies are financially more advanced and have a good mix of banks and capital markets while low-income and lower-middle-income economies are financially less mature, and their financial systems are heavily dominated by banks.

Figure 1: Ratio of Liquid Liabilities to Gross Domestic Product, 2011



PRC = People's Republic of China.

Sources: Beck, Demirgüç-Kunt, and Levine 2000, 2009; Čihák et al. 2012.

Despite this diversity in Asia's financial landscape, discussions on the region's finance sector development tend to center on the challenges facing the upper-middle-income, or middle-income economies in general. This explains why the development of bond markets, especially corporate bond markets, receives so much attention. Certainly bond market development is an important priority for Asia, but it is an issue that is less relevant for the region's low-income and lower-middle-income countries, some of which do not even have bond markets. The much more urgent priority for bank-dominated economies is banking system reform that mobilizes domestic savings, lowers the cost of capital, improves access, and channels credit to the most productive sectors. In particular, creating a more competitive environment is an indispensable ingredient of any meaningful banking reform.

The central objective of this working paper is to briefly look at the key features and reform priorities of the financial systems in five low-income and lower-middle-income countries in developing Asia, namely Bangladesh, Cambodia, Georgia, Mongolia, and Papua New Guinea (PNG). They are from different subregions and have diverse socioeconomic characteristics, but they all share relatively underdeveloped financial systems. We hope that our examination of these five countries will allow the reader to gain at least some understanding of the salient challenges to finance sector development in low-income and lower-middle-income countries in Asia. The next section will provide a brief overview of the financial system in each of the five including the main reform priorities. The final section concludes the paper.

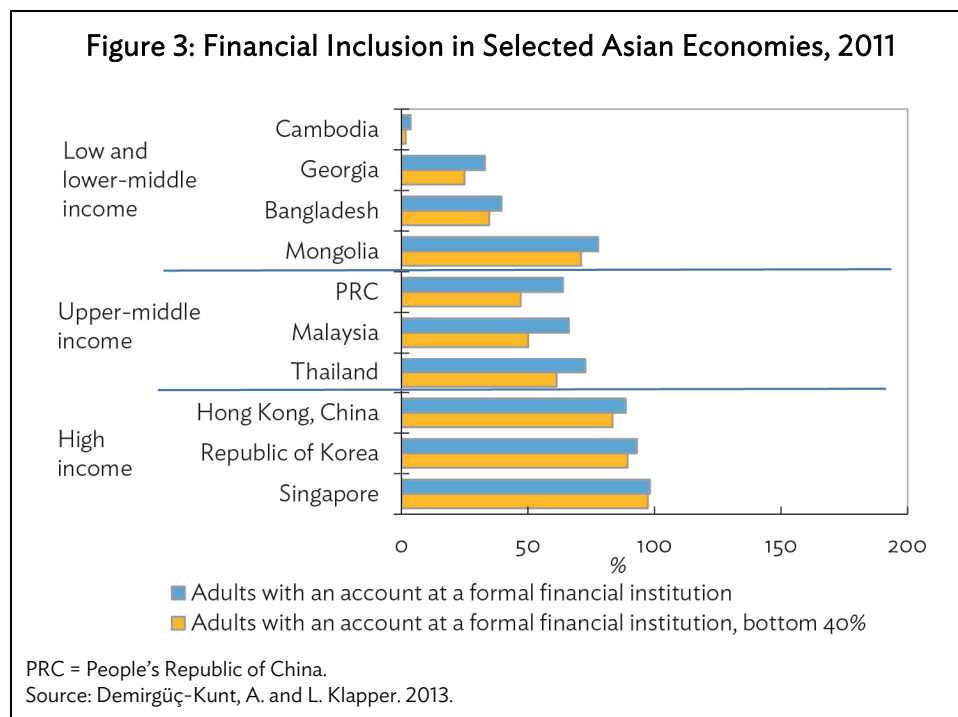
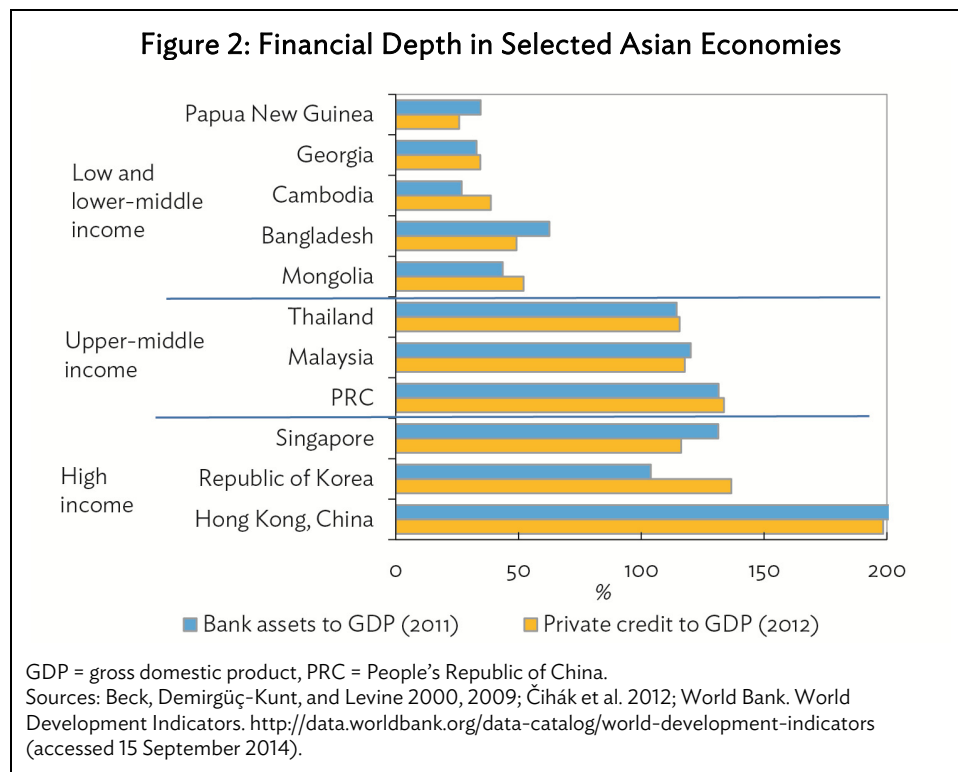
II. COUNTRY EXPERIENCES

Figure 2 indicates that low- to middle-income countries such as Bangladesh, Cambodia, Georgia, Mongolia, and PNG have finance sectors that are small relative to the size of their economies and compared with richer economies in the region. Furthermore, their finance sectors are dominated by the banking sector. Low levels of financial access, especially among the poor, also characterize countries with underdeveloped financial systems (Figure 3). Clearly, these countries face an urgent need to expand their financial systems as well as to broaden financial inclusion. We examine in more detail the key features of the finance sectors of the five economies and what important measures are needed to further develop their finance sectors.

A. Bangladesh

1. Background and Key Features

In the 1970s and 1980s, Bangladesh's financial system was dominated by state-owned commercial banks (SCBs). Guided by Bangladesh Bank's (central bank) twin policies of directed credit and administered low interest rates, the operations of these banks caused distortions in resource allocations among sectors. In the late 1990s, the government launched a finance sector reform program mainly to (i) allow greater autonomy to Bangladesh Bank and to strengthen its capabilities and technical skills, (ii) strengthen prudential regulations and supervision, and (iii) restructure the management and internal processes of SCBs and to privatize some banks. Bangladesh Bank gradually moved to tighten prudential regulations to bring banks closer to international standards. While competition in the banking sector improved, the sector was plagued by high nonperforming loan (NPL) ratios and a lack of adequate capital.



A second finance sector reform program was launched from 2000 to 2006 focusing on the development of financial institutions and ensuring risk-based regulations and supervision by Bangladesh Bank. Market regulations were simplified to facilitate auctions of treasury bills and bonds, and the implementation of Basel norms began. The excessive exposure of the financial institutions to capital markets, the rapid rise in their lending to retail investors in the market, and the subsequent

market collapse at the end of 2010, however, exposed their vulnerability and lack of internal discipline that manifested in higher NPL ratios. The Bank Company (Amendment) Act of 2013 was therefore enacted to provide greater supervisory authority to Bangladesh Bank to oversee SCBs.

As of September 2014, the banking sector consisted of 4 SCBs, 4 government-owned specialized banks dealing in development financing, 39 private commercial banks, and 9 foreign commercial banks. The sector had a combined network of 8,427 branches (Table 1 and Table 2). The financial system also includes 31 nonbank financial intermediaries (NBFIs), 699 licensed microfinance institutions (MFIs), 77 insurance companies including 2 state-owned ones, and 2 stock exchanges. The banking sector accounts for roughly 90% of finance sector assets. The nonbank finance sector comprising leasing and finance companies is small but growing. The capital market is also growing but still remains small, and long-term contractual savings institutions are virtually absent. In terms of MFIs, Bangladesh has the highest penetration in the world with borrowing clients that constitute about 20% of the total population.

The composition of banking system assets and deposits has changed overtime. The share of SCBs in the banking system has been declining while private banks have been gaining larger market shares. While in fiscal year (FY) 2001 SCBs accounted for 46.5% of assets and 50.9% of deposits, in FY2013, the share of private banks in total assets rose to 61.5% and in deposits to 62.4%. Structural changes in the economy away from agriculture to services and manufacturing led to greater credit demand from the private sector, and private banks responded more readily to meet that demand. A rapid rise in trade and working capital lending and term loans to industries and lending to larger agricultural firms and to small and medium-sized enterprises boosted the market share of private banks. In contrast, the share of SCBs declined due to their weak balance sheets, the slow growth in traditional borrowers, high NPL ratios, and unresponsive business processes (World Bank 2010).

The finance sector has steadily grown with total bank deposits to gross domestic product (GDP) rising to 49% in FY2014 from 35% in FY2006. The size of the capital market also grew to 21.7% of GDP from 4.7% in the same period. Financial liberalization policies have helped deepen the country's finance sector such as the removal of interest rate controls, more flexible rules for opening new private banks, and changes in the exchange rate regime including current account convertibility of the taka. Other factors that have helped broaden the country's finance sector include corporatization of SCBs and the spread of banking operations to rural areas. Sound macroeconomic management evident in low and stable inflation, low fiscal deficits, and small public debt as a percent of GDP also contributed to financial deepening.

2. Challenges and Reform Priorities

High NPL ratios pose major risks to banking system soundness. Several financial scams involving both SCBs and private banks from 2009 to 2012 and the subsequent tightening by Bangladesh Bank of classification and provisioning requirements also raised NPL ratios. At the end of 2014, the ratio of gross NPLs to total loans by the banking system stood at 9.7% with government specialized banks having the highest NPL ratios. The interest rate spread of 5.2% in 2014 was quite large reflecting management inefficiency and lack of competition among banks. The key challenge is strengthening the banking system by improving competition and efficiency.

Table 1: Bangladesh Financial System Structure, 2002–2013

		All Banks	SCBs	SBs	PCBs	FCBs	Finance companies ^{a/}	Microfinance Inst. ^{b/c/}	Securities markets ^{d/}
2002	Number	51	4	5	30	12	26	624	230
	Asset (\$ billion)	22.2	10.3	2.6	7.8	1.5	0.3	0.7	1.1
	% of banking system assets	100.0	46.3	11.8	35.0	6.9			
	% of GDP	46.8	21.7	5.5	16.4	3.2	0.7	1.4	2.4
2008	Number	48	4	5	30	9	29	4,200	294
	Asset (\$ billion)	48.3	15.0	3.2	26.2	3.9	1.3	2.4	11.5
	% of banking system assets	100.0	31.1	6.7	54.2	8.0			
	% of GDP	52.7	16.4	3.5	28.5	4.2	1.7	2.6	14.4
2013	Number	56	4	4	39	9	31	699	529
	Asset (\$ billion)	94.2	25.2	5.3	57.9	5.8	4.7	4.3	24.1
	% of banking system assets	100.0	26.7	5.6	61.5	6.1			
	% of GDP	62.8	16.8	3.5	38.6	3.8	3.2	2.8	16.1

FCB = foreign commercial bank, GDP = gross domestic product, PCB = private commercial bank, SB = specialized bank, SCB = state-owned commercial bank.

Notes:

^a Nonbank financial institutions.

^b Total loan outstanding of microfinance institutions/nongovernment organizations plus Grameen bank.

^c Total Licensed microfinance institutions/nongovernment organizations until June 2013.

^d Dhaka Stock Exchange market capitalization is in the asset row. Listed companies shown under number of firms exclude mutual funds.

Sources: Bangladesh Bank Annual Report 2002, 2008, 2013; Government of Bangladesh Microcredit Regulatory Authority 2004, 2009, 2013 and Securities and Exchange Commission Annual Report 2010, 2013; Grameen Bank Annual Report 2002, 2008, 2013.

Table 2: Bangladesh Banking Sector Indicators, 2000–2013

Indicators	2000	2005	2010	2011	2012	2013*
Number of bank branches	6,119	6,402	7,658	7,961	8,322	8,427
Rural	3,659	3,764	4,393	4,551	4,760	4,827
Urban	2,460	2,693	3,265	3,410	3,562	3,600
Total assets (\$ billion)*	21.6	33.3	70.2	82.4	88.9	94.2
Total advance (\$ billion)*	11.6	18.2	37.2	45.1	48.8	53.2
Total deposit (\$ billion)*	13.8	23.1	48.8	57.8	61.5	71.6
Private sector credit (% of total domestic credit)*	72.6	75.3	79.6	78.6	79.2	79.1

Note: * means estimated at fiscal year (July–June).

Source: Bangladesh Bank Annual Report 2000, 2005, 2011, 2012, 2013.

With regard to the capital market, while there are now two stock exchanges—the Dhaka Stock Exchange and the Chittagong Stock Exchange—the capital market still plays only a small role in financing industrial investment compared with banks and NBFIs. In FY2013, only \$0.2 billion was raised from the capital market through new capital issues compared with \$5.3 billion in disbursements from banks and NBFIs. Capital market indicators picked up sharply toward the end of 2007 as financial institutions including banks invested aggressively in the market in the form of direct investment and margin loans as well as through their subsidiaries. Excessive investment by financial institutions and considerable participation by institutional and individual investors led to an asset bubble that burst in December 2010. By the end of June 2011, the main Dhaka Stock Exchange Index had fallen by 31.4% from its 5 December 2010 all-time high. Despite recent improvements in terms of index movement

and trade volume, the capital market remains shallow, volatile, and underdeveloped. Developing the capital market requires a clear regulatory framework and sound supervision.

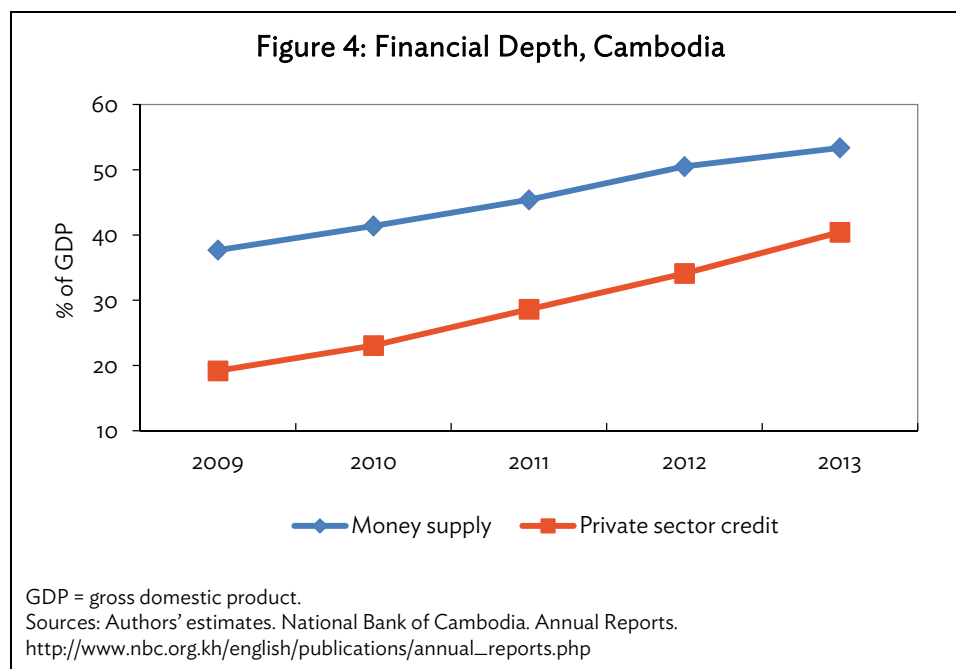
B. Cambodia

1. Background and Key Features¹

With a relatively strong banking subsector, financial deepening in Cambodia has accelerated with an increased supply of financial services. The broad money supply (M2) to GDP has risen from 13% in 2001 to 53.4% in 2013 (Figure 4). Credit to the private sector has correspondingly risen from 6% of GDP to 40.4% of GDP and total deposits from 10.4% of GDP to 49.1% of GDP in the same period.

The banking system has been fully liberalized. There have been no regulatory constraints on loan and deposit interest rates since 1995, and there are no legal barriers to bank entry including foreign banks. As of 2013, there were 35 commercial banks of which 25 were registered banks and 10 were foreign bank branches. Most commercial banks have majority foreign ownership. In addition, there were seven specialized banks including one state-owned bank: the Rural Development Bank. With the exception of that one state-owned bank, the banking system is entirely owned by the private sector.

Total bank assets reached 83% of estimated GDP in 2013 compared to 22% in 2005 reflecting improved public confidence in the banking system and financial deepening. Bank assets accounted for 95% of total finance sector assets in 2013. Most bank operations in Cambodia are in urban areas (mostly Phnom Penh) except for ACLEDA Bank, the largest bank which has branches in every province and district. In 2013, market shares in terms of assets and deposits of the top five banks were 55.1% and 65.2%, respectively. The banking industry had a solvency ratio of 24.8% in 2013, much higher than the minimum solvency requirement of 15%.



¹ This section is based on ADB (2014a).

The government has undertaken important initiatives to establish a capital market while recognizing that it is imperative to meet minimum prerequisites before a stock market becomes a significant tool to raise capital. To help provide a regulatory framework, two fundamental laws were enacted: the Law on Government Securities and the Law on Issuance and Trading of Nongovernment Securities. It also established the Securities Exchange Commission of Cambodia to supervise the operation of the securities market—in particular the Cambodia Securities Exchange—that was set up in July 2011.²

2. Challenges and Reform Priorities

The role of the National Bank of Cambodia (NBC) (the central bank) in formulating and implementing monetary policy for macroeconomic and financial stability including as lender of last resort has been significantly limited by the high degree of dollarization of the economy. Monetary policy interventions are less effective in a very thin foreign exchange market. In the absence of an effective interbank and domestic bond market, the NBC does not have the necessary tools to implement monetary policy and therefore mainly relies on adjusting reserve requirements for the banking system. With the rapid growth of the banking sector, there is a need to strengthen NBC supervisory capacity.

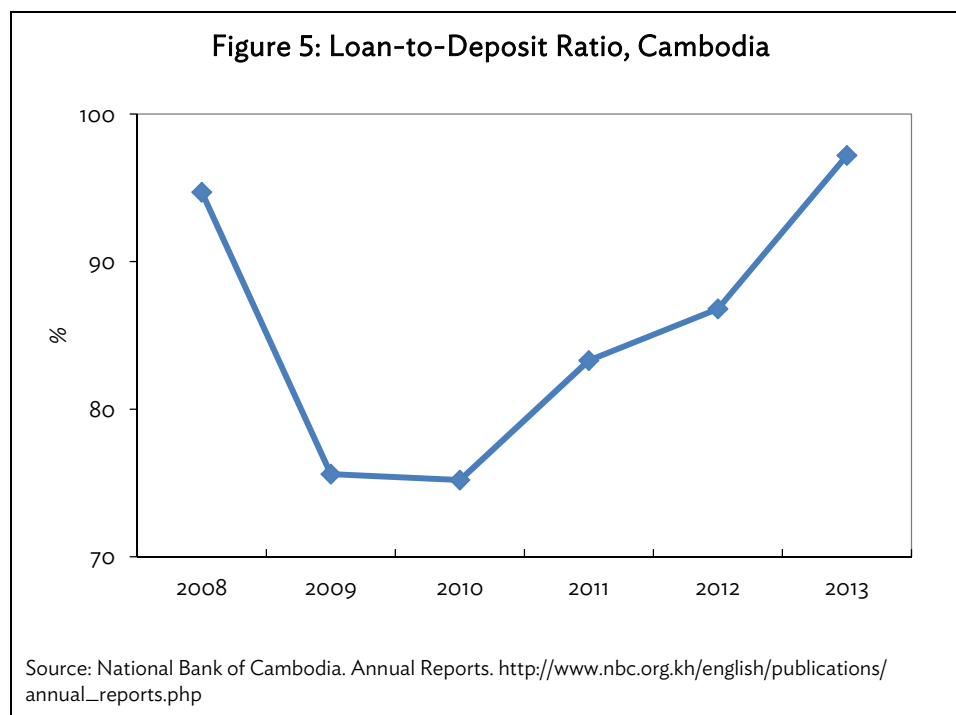
Notwithstanding rapid credit growth, access to formal financial services was limited to fewer than 2 million people or 13% of the total population as of 2013.³ With most finance sector development taking place in urban areas, particularly in Phnom Penh, there is a need to improve formal financial access in rural areas. Raising financial literacy is a critical component of extending access to financial services, especially for poor people in hard-to-reach areas.

The private sector credit-to-GDP ratio has increased rapidly from 28.6% in 2011 to 40.4% in 2013 thanks to rigorous economic activities. Intensifying competition among banks for market shares has increased their risk appetites, in particular those of smaller and medium-sized banks. New banks with offshore funding entering the market since 2011 contributed to credit expansion; however, overseas liabilities are not subject to reserve requirements (IMF 2014). Credit growth outpaced domestic deposit growth from 2011 to 2013 consequently reducing the share of excess reserves to deposits. In December 2013, the loan-to-deposit ratio was above 97%, the highest since 2008 (Figure 5). The rapid expansion of loans to construction and real estate to over 31% year-on-year in December 2013 and rising loan-to-value ratios from 60% to 70% could trigger financial stability risks if not properly monitored and managed.

The stock market in Cambodia is at a very early stage of development; it will take several years for it to mature. Following the establishment of a more effective equity market, debt markets—including a corporate bond market—will need to be developed. This, however, would require a sound regulatory framework, related benchmarks (usually in the form of a yield curve for government bonds), and the establishment of a credit rating agency. The Ministry of Economy and Finance has continued to develop market procedures for treasury bills, while the government's debt management strategy envisages the issuance of government bonds no earlier than 2018. While a corporate governance code has been introduced by the Securities and Exchange Commission, good governance practices need to be further promoted.

² The exchange is a joint venture of the Ministry of Economy and Finance and the Republic of Korea Exchange.

³ There were 1,935,941 borrowers from banks and MFIs in 2013.



Issuing implementing regulations for the Law on the National Bank of Cambodia and the Law on Banking and Financial Institutions will contribute to building risk mitigating measures and higher levels of confidence in the finance sector. Adopting the national strategy to promote the use of the local currency, the riel, is also expected to progressively uphold public confidence in it. The institutional capacity of the regulatory and supervisory authorities needs continued strengthening in terms of manpower and technical expertise to keep pace with the rapidly developing finance sector.

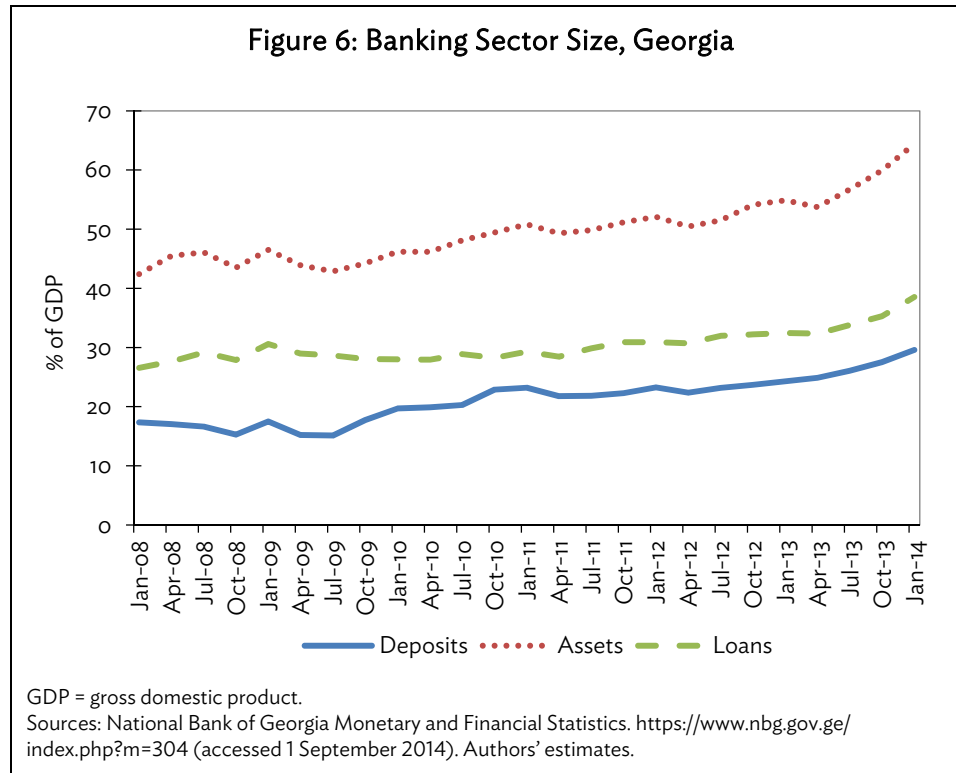
As emphasized by the IMF (2014), there is a need to fully enforce reserve requirements to include bank funding from abroad in the reserve base to help contain credit growth and improve monetary control. The IMF (2014) also raised the need to closely monitor maturity mismatches for early signs of increasing rollover risks and to consider introducing loan-to-deposit ratio limits as well as higher risk provisioning for new loans, especially for sectors that are considered high risk. Data collection and quality control as well as reporting mechanisms for the construction and real estate sector should be strengthened and monitored.

C. Georgia

1. Background and Key Features

Georgia's finance sector is dominated by the banking sector. There are 21 commercial banks—20 of which are foreign-controlled—that at the end of 2013 accounted for more than 90% of the financial system's assets. Georgia's banking sector is globally integrated and among the region's most sophisticated (OECD 2011). The banking sector expanded steadily between 2007 and 2013 (Figure 6) characterized by a growing level of financial intermediation with total banking sector assets reaching 64.4% of GDP by 2013, up from 42.4% at the end of 2007. Encouraged by macroeconomic stability, strong financial performance, and the sustainable debt position, bank deposits reached 29.6% of GDP in 2013, rising from 17.3% at the end of 2007. The sector was subjected to considerable stress during

the twin crises of the conflict with the Russian Federation in August 2008 and the global financial turmoil; nevertheless, because of the National Bank of Georgia's (the central bank) proactive policy stance underpinned by its institutional independence, the banking sector remained resilient to exogenous shocks. No banks failed during the global financial crisis.

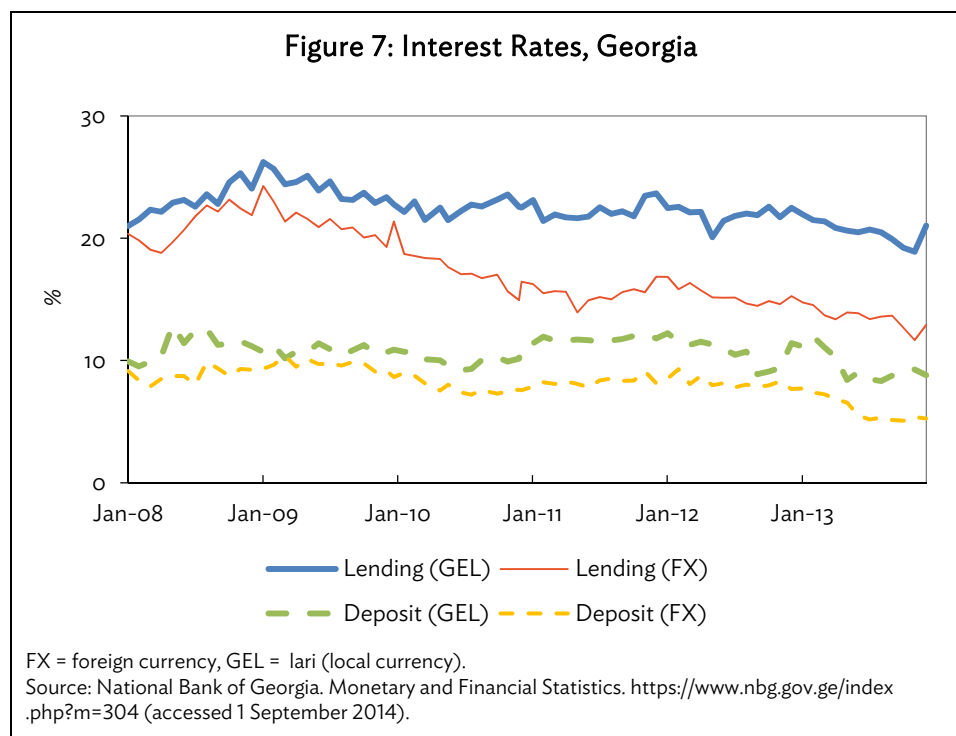


Interest rates and spreads decreased overtime but still remain relatively high (Figure 7). At the end of 2013, interest rates on forex-denominated loans and deposits were 11.7% and 5.4%, respectively compared with levels of 20.4% and 9.1% at the end of 2007. According to KPMG (2014), even though nominal lending rates are higher in Georgia than in some of its peers, the combination of lending rates and service fees/charges are still lower.

The banking sector is highly concentrated. The top five banks controlled 76.4% of assets in 2013 with the remainder distributed among the other 16 banks. Watson and Liddell (2013) pointed to steep competition and pressures on margins. Smaller banks are especially under pressure to improve their business models and to deliver enhanced performance to remain competitive and profitable.

The banking sector has played a limited role in financing the real economy and in investing in activities that are needed to reduce the country's persistent trade and current account deficits. Bank credit growth reached 21% in 2013 but was predominantly channeled into trade (24.2%) followed by industry (9.3%) and construction (4.3%). Loans to households remained sizable in the total loan portfolio and amounted to 46.6%.

Georgia has limited access to long-term capital to finance growth. The securities market is at an early stage of development and has a narrow investor base and shallow market liquidity. Market capitalization peaked at 13.7% in 2007 but fell in subsequent years to just 6% in 2012 (WDI).



2. Challenges and Reform Priorities

The government identified limited access to financial resources as a critical obstacle to the country's economic development due to insufficient savings and internal resources necessary for long-term financing and investment. The priority measures for overcoming this obstacle are developing financial intermediation and mobilizing investment. According to the World Economic Forum (2013), Georgia's financial system needs to do much more to improve access to credit (98th among 148 countries in 2013) and the affordability of financial services (83rd). Enhancing the legal, regulatory, and institutional framework for consumer protection and supporting innovative technology for mobile financial services can increase access to financial services.

The securities market in Georgia is at an early stage of development with a regulatory framework that is still evolving. There are gaps in the required capacity and technology to trade equities and bonds, and demand is rather weak. A limited investor base due to the absence of institutional investors, the dollarization of the financial market, a lack of trust in the local currency and institutions, and poor liquidity all combine to constrain market growth. Reforms of the pension system will, once implemented, address some of the challenges, but without developing the capacity of the local fixed income market, fund managers are forced to invest in foreign currency thereby increasing foreign exchange risks (McKean et al. 2013).

Among the key challenges relating to the finance sector are continuing volatility in business cycles that is exacerbated by external shocks; a stubbornly high level of dollarization at about two-thirds of loans and deposits posing risks to micro, small, and medium-sized enterprises and to individual borrowers; high levels of foreign currency lending and less than robust lending standards; and lending portfolios that have expanded fairly rapidly and may now be under stress (McKean et al. 2013).

Developing the capital market can expand the contribution of the banking sector to economic growth and strengthen the nonbank finance sector to underpin domestic savings. Critical factors include the development of the primary and secondary markets for government securities and corporate funding options for the (i) implementation of an effective and appropriate institutional structure to include security market regulations and legal and accounting/audit frameworks, (ii) cultivation of a benchmark debt issuance program, and (iii) expansion of the institutional investor base. The growth of pensions and other savings can create an important additional source of investment and can strengthen the country's social safety net. These long-term funds can be invested to stimulate the development of capital markets, especially interbank money markets and secondary debt markets that are critical for domestic resource mobilization (ADB 2013).

D. Mongolia

1. Background and Key Features

From 1921 to 1990, Mongolia had a mono-banking system in which all banking activities were conducted by the State Bank of Mongolia. A two-tiered banking system was established in 1990 when a banking license was granted to the country's first commercial bank. Following the nationalization and subsequent privatization of several banks, by 2006 the whole banking sector eventually came under the control of the private sector. Despite rapid finance sector development, policy reforms, and private sector innovations, the country witnessed several finance sector shocks resulting in the collapse of a number of MFIs and the restructuring or closure of some banks in the mid-1990s and late 2000s. The State Bank, an SCB, was established as the good bank taking on the good assets of two failed banks in 2009.

As of May 2015, 14 domestic commercial banks dominated the finance sector accounting for over 80% of total financial assets. Banking sector assets grew from 86% of GDP in 2012 to 103% of GDP in 2014 with the top 5 banks controlling about 80% of these assets. While lending to rural areas and the agriculture sector remains relatively limited, Mongolia has one of the highest banking branch penetration rates in the world at 1 bank branch per 15,257 residents. A substantial share of the population (78% in 2011) has an account at a formal financial institution and around 10% of micro, small, and medium-sized enterprises have regular access to formal financial services.⁴

The Mongolian Stock Exchange (MSE) was established in 1991 and grew out of the privatization of state-owned assets in the late 1990s. With some 238 listed companies and very low trading volumes, MSE's market capitalization equaled around 6.6% of GDP at the end of 2014.⁵ Annual turnover as a share of GDP declined to 0.1% in 2014 from 3.2% in 2011. Unlike in all developed and most developing countries, no bank stocks are currently listed on the exchange.⁶ Recent regulatory reforms allow for more participation of financial institutions in the capital market. To date, three custody licenses have been granted to the three largest commercial banks, and three investment fund management companies have been recently established. Regulators are also seeking to diversify the investor base. Trading in government securities began on the MSE in late 2014. This has allowed a broad range of investors to actively engage in the security trade that was previously dominated by a few commercial banks. While there have been improvements in primary government bond market

⁴ Mongolia ranks 61 out of 189 countries in terms of access to credit in the 2015 World Bank Ease of Doing Business Survey.

⁵ Fifteen listed companies constitute about 75% of total stock market capitalization.

⁶ Previously, two large banks were listed and were subsequently taken into conservatorship within a year.

development, nearly all bonds are bought by banks and held to maturity; there is virtually no secondary market trading. This impairs the use of government bonds as a baseline for pricing and the creation of a corporate bond market.

The interest rate subsidized price stabilization program⁷ and housing mortgage program have contributed to significant credit expansion but are gradually being tapered. To reduce the likelihood of asset bubbles and a buildup of foreign exchange risk driven by high fluctuations in the domestic foreign exchange rate market, the Bank of Mongolia (BOM) (the central bank) raised the risk weights assigned to the Mongolian tögrög (MNT) and foreign-currency-denominated mortgages in July 2014 to 50% and 100%, respectively, and required 1% loan loss provision for all new loans. In the wake of the economic slowdown and increased volatility in financial markets, the minimum capital requirement for banks was increased from MNT16 billion to MNT50 billion in April 2015. Consequently, banks are well-capitalized; the capital adequacy ratio stood at 17.7% at the end of 2014, well above the international benchmark. The policy rate was increased from 12% to 13% in January 2015, and policy lending under the price stabilization program and the mortgage program was tapered (see Box). In light of the economic slowdown, as of April 2015 loan growth had slowed to 4.7% year-on-year from a peak of 75.4% in November 2011. Rapid loan growth over the past few years has further strained bank liquidity with a high loan-to-deposit ratio of 115% at the end of April 2015, up from 72.7% at the end of 2010.

With regard to capital markets, the Securities Market Law and Investment Funds Law that were enacted in January 2014 are seen as positive developments in increasing the efficiency and liquidity of the capital markets. The Securities Market Law offers a number of improvements that make Mongolian assets more attractive to international investors such as allowing companies to be simultaneously listed on international and domestic stock exchanges⁸ and strengthening requirements for public disclosure, transparency, and accounting. The Investment Funds Law enables the operation of mutual funds and private funds in the country.

2. Challenges and Reform Priorities

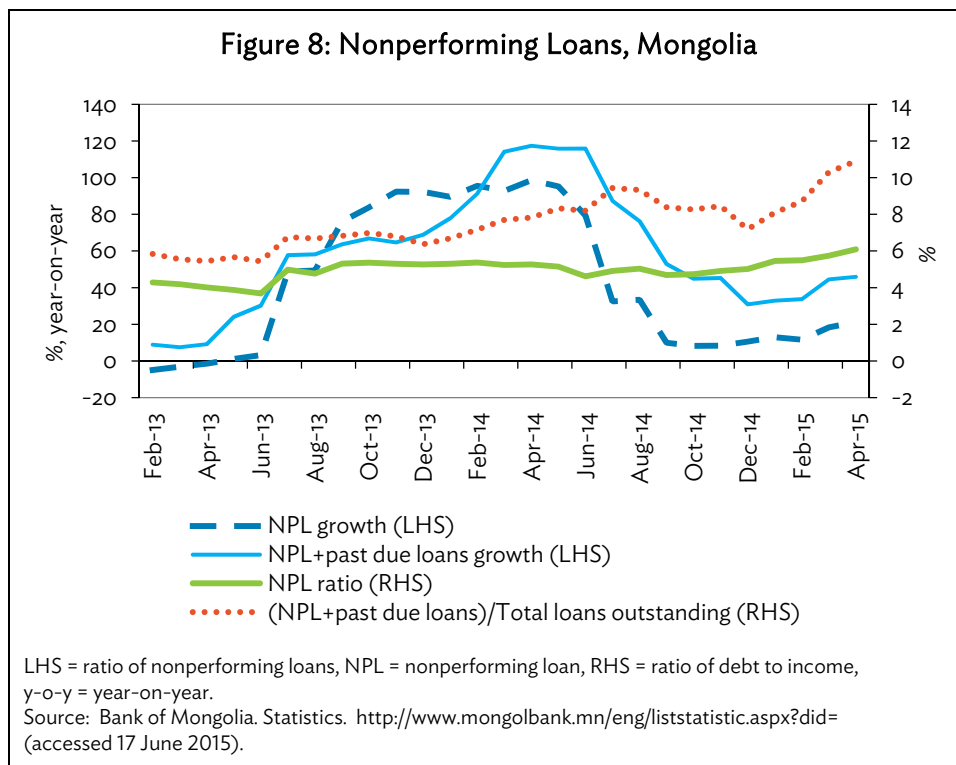
The failure of several commercial banks in 2007 and 2008 and in 2013 has raised concerns about the impact of falling commodity prices, the deteriorating business environment for the mining industry, and the rapid lending growth that have increased banking sector vulnerability.⁹ For instance, the failure of the fifth largest bank in 2013, the Savings Bank, was directly related to economic uncertainty and weak regulatory enforcement.¹⁰ In April 2015, the ratio of NPLs over 90 days past due stood at 6%, but including loans under 90 days past due, the ratio was 10% (Figure 8). Slower economic growth and the MNT depreciation against the United States dollar have affected the repayment capacity of borrowers that relied on foreign currency earnings. NPLs in the trade sector alone increased to MNT155.9 billion in June 2014, twice as much as at the end of 2013.

⁷ The 2012 price stabilization program directed loans through participating commercial banks to major businesses operating in fuel supply, construction materials, and consumer goods to address supply-side bottlenecks contributing to high consumer price inflation in that year.

⁸ More than 30 companies with the country's best assets are listed in foreign markets.

⁹ Mining accounted for 36% of NPLs.

¹⁰ The Savings Bank became insolvent due to a bad mining loan to its holding company and \$120 million in accumulated losses from acquiring the poorly performing Post Bank.



Despite these challenges, the banking sector continues to have good potential for expansion in retail and agriculture. In the wake of liquidity constraints and rating downgrades, banks tend to be more transparent and adequately maintain governance to boost customer and investor confidence. In addition, Mongolian regulators have taken several measures over the past 2 years to improve corporate governance, transparency, and accounting and auditing practices. For instance, the corporate governance codex was revised in 2014, and all listed companies are required to follow it. The Financial Regulatory Commission is revising accounting rules and guidelines for listed companies to comply with international standards. In addition, the BOM has revised guidelines on banking corporate governance.

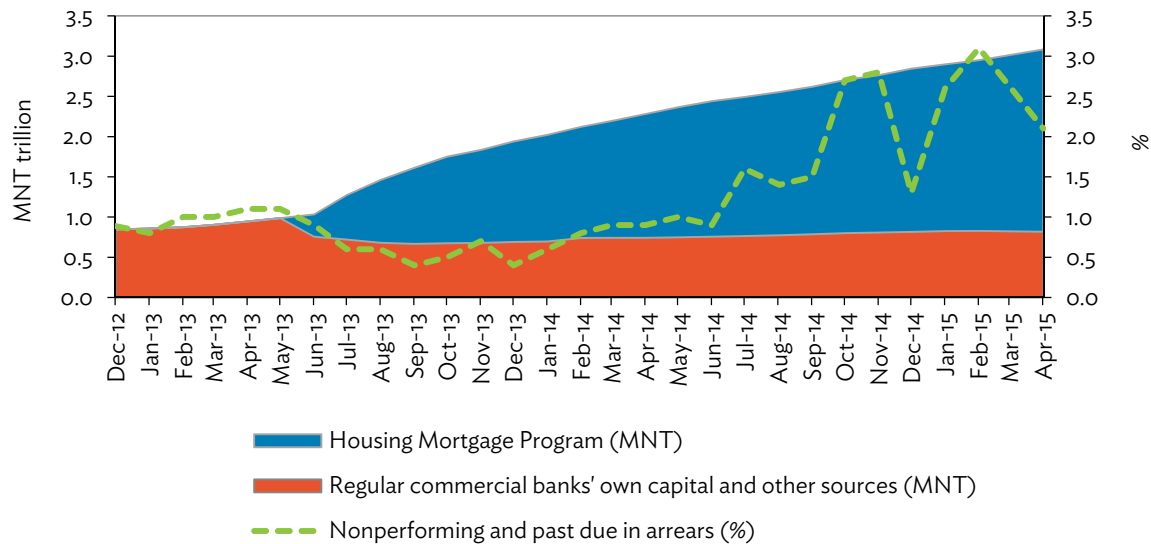
Given the rapid growth in credit over the past few years, tight liquidity conditions, and increasing NPLs, the finance sector remains fragile. Particular attention must be paid to augmenting supervision, enhancing the capacity of the BOM and the Financial Regulatory Commission, and adopting international standards for capital adequacy, accounting and auditing, and corporate governance. Furthermore, measures are needed to enhance the macroprudential policy framework to help ensure financial stability.

In the longer term, it is important to enhance the availability of long-term financing. When banks rely too much on short-term deposits, this generally leads to loan terms with shorter maturities. Moving toward long-term financing requires well-sequenced reforms to support the growth of equity markets, to enhance investor and consumer protection, to strengthen corporate governance, to develop a secondary government bond market, to strengthen the insurance market, and to create institutional investors that can provide long-term funding.

Mongolian Housing Mortgage Program

In June 2013, Mongolia embarked upon a housing mortgage program for apartments with fewer than 80 square meters of floor space. The program is implemented by the central bank through commercial banks at a discounted 8% interest rate. At the end of 2014, mortgages outstanding had increased by 46.7% year-on-year to 2.8 trillion Mongolian tögrög (MNT) (\$1.424 billion) with the number of mostly middle-income borrowers rising by 37.3% to 66,334. Over 70% of outstanding mortgages were made under the program including a large number of refinanced mortgages. In March 2014, MNT0.3 trillion of these mortgage loans were securitized through the Mongolian Mortgage Corporation benefiting from a central bank guarantee with mortgage-backed securities replacing mortgages on bank balance sheets at a subsequently zero capital charge. The weighted average interest rate for new mortgages fell from 16.6% in May 2013 to 10.6% in September 2014.

Outstanding Mortgage Loans



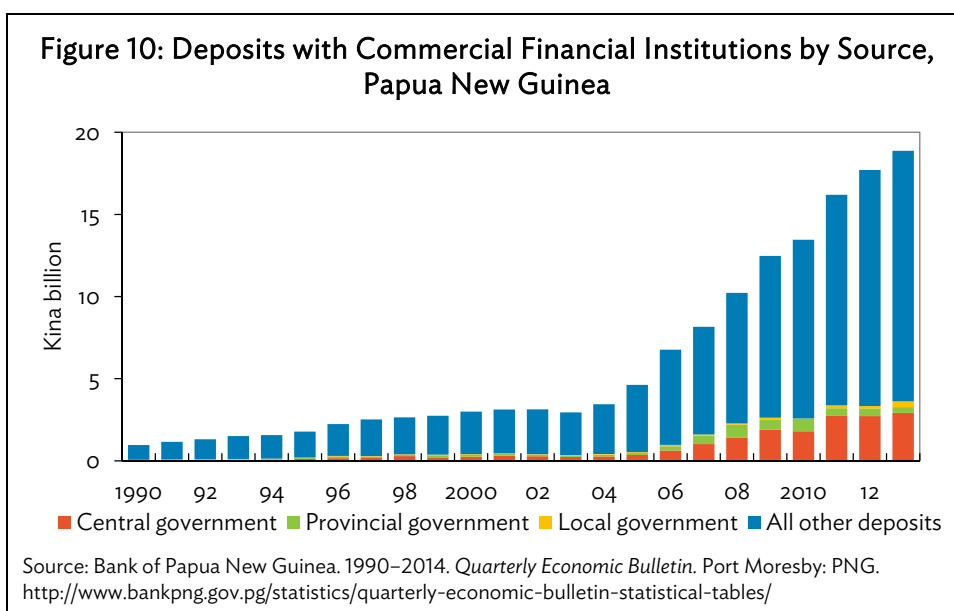
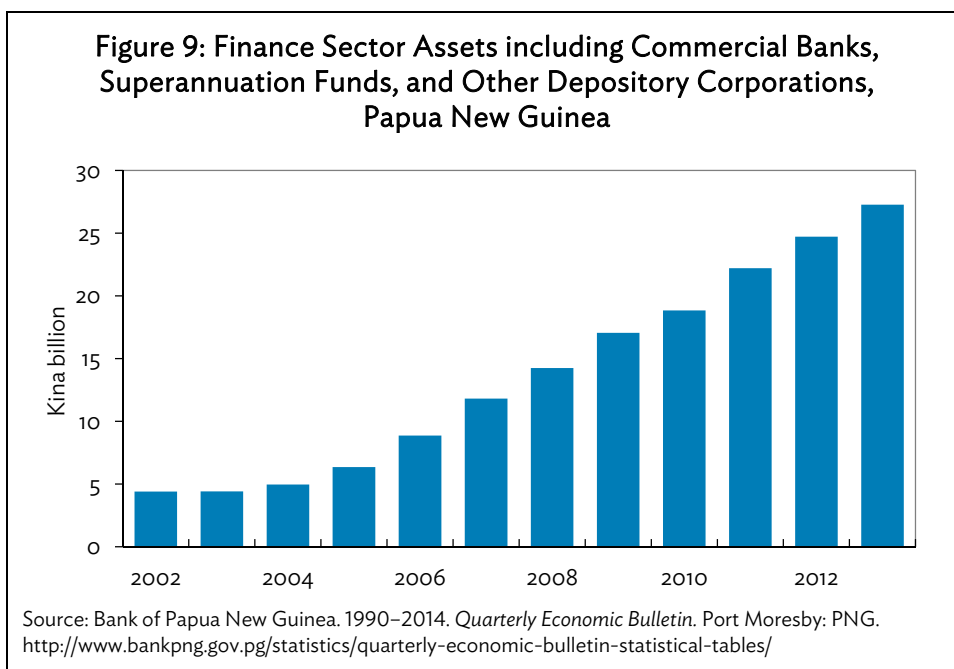
Source: Bank of Mongolia. Statistics. <http://www.mongolbank.mn/eng/liststatistic.aspx?did=> (accessed 17 June 2015).

E. Papua New Guinea

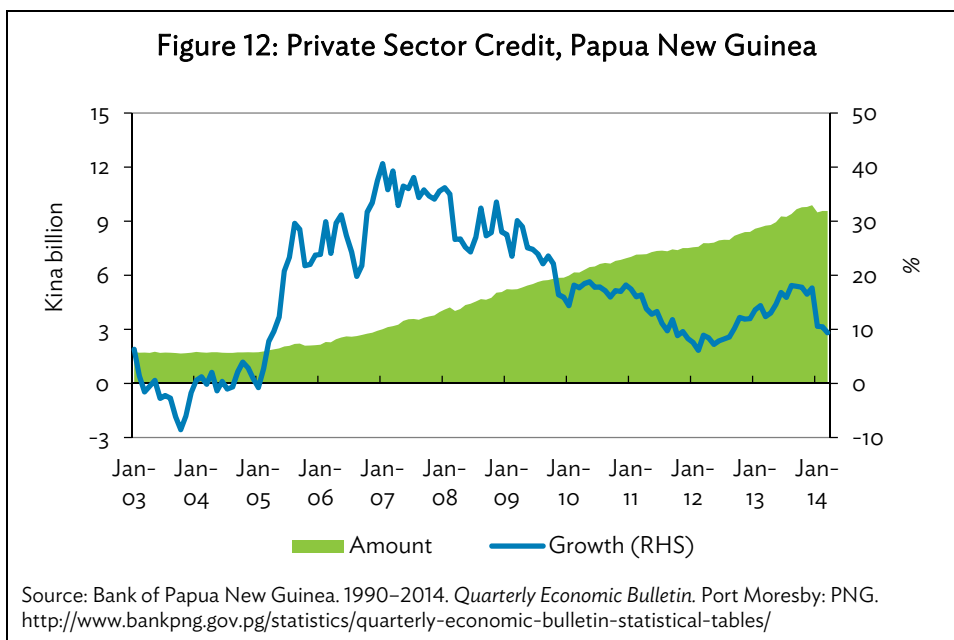
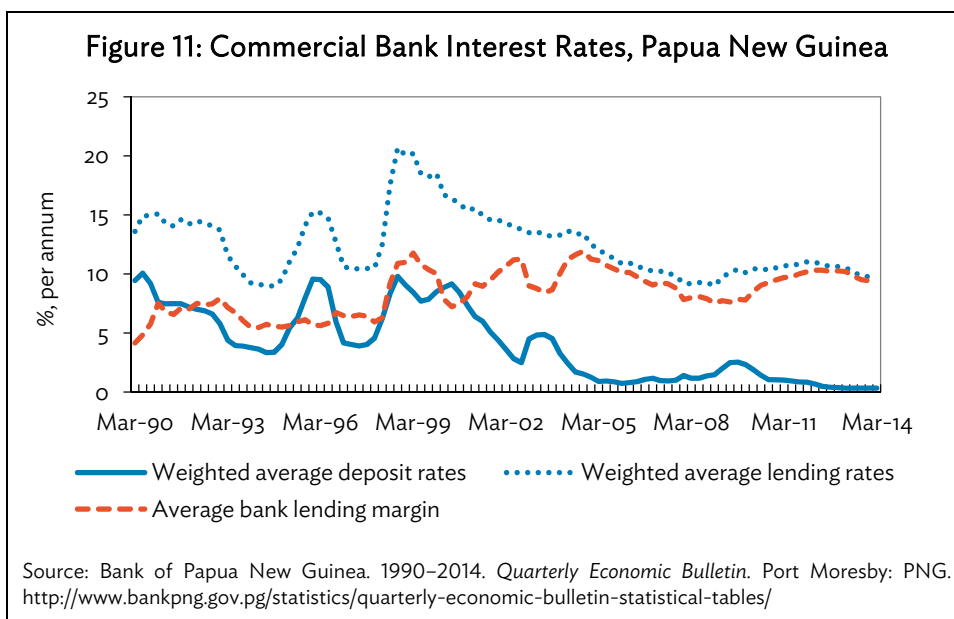
1. Background and Key Features

From independence in 1975 until the late 1990s, the finance and banking sector in PNG experienced limited growth and development. Private investment was constrained by weak regulatory frameworks, the existence of a number of poorly run state-owned financial institutions, volatile economic growth, balance of payments crises, rising public debt, and falling real per capita incomes (Batten 2008). By the end of the 1990s, the finance sector was effectively on the verge of collapse. The Bank of PNG (central bank) was required to fund public debt obligations which increased inflation and contributed to domestic interest rates in excess of 20% per annum. The state-owned PNG Banking Corporation and Rural Development Bank were subject to extensive political influence on interest rates, lending policies, and individual lending while the two largest superannuation funds were illiquid (IMF 2000). Against this backdrop, financial services were both expensive and restricted to people with formal employment who resided in large urban centers.

Since the early 2000's, however, the finance sector has undergone a significant revival increasing its profitability, and it now provides a much broader and more affordable range of financial services. Between 2002 and 2013, finance sector assets grew by an average of 18% per annum underpinned by rapid growth in commercial bank deposits and solid investment returns (Figures 9 and 10). During this period, commercial banks were able to maintain capital adequacy ratios well above prudential standards (typically above 25%), with more than half of their assets held in government securities or cash. Profitability has also been high with the three largest banks—Bank of the South Pacific, ANZ, and Westpac—all posting above double-digit average returns on equity. PNG's finance sector has also displayed a high level of resilience to global shocks. Recent IMF (2011) stress tests indicated that the banking system remains at a low risk of distress with minimal potential impact from interest rate or credit shocks in the near term.



Several factors have underpinned the turnaround in PNG’s finance sector over the last decade. Firstly, following the third major macroeconomic crisis in 8 years, in 2000 the government implemented a comprehensive finance sector reform program (Batten 2012). This included the privatization of the state-owned PNG Banking Corporation, the enactment of a new legislative framework for an independent central bank with strong supervisory powers and a mandate for price stability (Central Banking Act 2000), and promulgation of enhanced governance and prudential standards for financial institutions (Financial Institutions Act 2000 and Superannuation Act 2000). Complementing these structural reforms was an improvement in macroeconomic management. Fiscal discipline enabled the central bank to stabilize price growth, which in turn encouraged commercial banks to begin lowering lending rates and to use their rising deposits to fund an expansion in private sector lending (Figures 11 and 12).



Structural reforms outside the sector also helped to promote financial inclusion. Most notably, the liberalization of a government monopoly over mobile telecommunications in 2006 facilitated a rapid expansion in access to services from 5% to an estimated 75% of the population. Currently, five mobile financial service providers have in excess of 300,000 users, and the number of agents for financial services exceeds the number of bank branches in the country (ADB 2014b).

2. Challenges and Reform Priorities

While significant progress has been made over the last decade, several challenges remain. Although mobile banking is opening up new opportunities, it is estimated that about 85% of the country's population does not have access to financial services. This acts as a major impediment to the monetization of the rural economy and a significant constraint to the growth of small and medium-sized enterprises.

With just three major commercial banks and two large superannuation funds, the efficiency of PNG's domestic financial intermediation also continues to compare unfavorably with that of major economies in the Asia and Pacific region (ADB 2014b). Retail foreign exchange rates maintain margins well in excess of 10%. Similarly, the average spread between lending rates and deposit rates remains at around 10% (Figure 11). No secondary market in government debt exists, meaning government securities cannot be easily liquidated, especially in times of stress.

In spite of large margins, commercial banks also remain reluctant to lend. At around 25% of GDP, the level of credit provided to the private sector remains one of the lowest in the Asia and Pacific region (ADB 2012). In part, this reflects the challenges that financial institutions face in accessing suitable collateral and the limited confidence in contract enforcement procedures within the country. A particular constraint is the absence of clear titles to property, especially land, and associated difficulties with entering into reliable leasehold agreements with traditional landowners.

The underlying reasons for PNG's relatively small and costly finance sector—and the small size of the formal economy more broadly—are complex. Merely promoting reforms that enable greater accessibility to credit or financial services would not necessarily overcome this complexity. For economywide progress to be made, deep structural issues need to be addressed including the access of rural communities to markets and urban services, national land reform and registration, improvements in law and order including the power of the courts to enforce contracts, and national literacy and education levels.

Looking forward, a number of policy priorities stand out.¹¹ Broadly speaking these can be put into two categories: those that aim to deepen local capital markets and those that aim to promote higher levels of financial inclusion.

(i) Deepening local capital markets

With the government remaining the sole issuer of domestic bonds, widening participation in the debt market is a key next step in financial market development. A more developed debt market will increase the supply of investible resources in the economy facilitating the flow of foreign capital at a

¹¹ These priorities are discussed in more detail in ADB 2014.

time of growing interest associated with the commencement of liquefied natural gas exports and future resource project investments. Foreign participation will help deepen markets, reduce transactions costs, and reduce the cost of funding. Furthermore, a well-functioning government debt market would provide the benchmarks necessary for the market to make the risk-adjusted judgments required for future issuances of corporate debt.

(ii) Promoting financial inclusion and literacy

With an estimated 85% of the population lacking any form of bank or financial accounts, access to finance is a critical impediment to private sector development. Further support is needed to implement the government's financial inclusion and literacy strategy that went into effect in 2014 under the leadership of the central bank. The vision calls for the creation of a regulatory framework and supporting policies that will widen access to financial products (particularly payments and savings) and will improve financial literacy such that banks have a million new clients by the end of 2015 bringing the share of the population with access to banking to 25%.

III. CONCLUDING OBSERVATIONS

The financial systems of Bangladesh, Cambodia, Georgia, Mongolia, and PNG are relatively underdeveloped as they are dominated by banks, and the capital markets—both equity and bond markets—play a smaller role than in financially more advanced Asian economies. This suggests that even as they begin to develop their capital markets, these countries should accord top priority to building up a sound, efficient, and well-regulated banking sector that channels credit to investment and to other productive activities. A competitive banking sector that allows the entry of new participants—including foreign and private banks—can promote efficiency. Reforming state-owned or state-linked banks can also yield sizable efficiency gains as the recent experience of the People's Republic of China demonstrates. Finally, directing credit to state-owned firms at the expense of the more dynamic private sector adversely affects growth. In fact, a well-functioning banking system that channels adequate amounts of reasonably priced credit is vital to a dynamic private sector which in turn holds the key to sustainable growth.

While specific reform priorities differ across countries, a common need in all five is good governance in financial institutions and markets. Poor governance erodes the link between finance and growth. For example, lending on the basis of commercial considerations is more likely to result in profitable, productive investments than lending on the basis of personal connections. Indeed, crony lending often ends up in “white elephants” and more generally in the waste and misuse of financial resources. Misallocation is not confined to banks but also extends to capital markets. Insider trading, for example, benefits owners and managers with inside information but destroys public confidence in the equity markets. Good governance requires effective prudential regulation of the financial system. Bank regulations can limit lending to owners, directors, and managers, and capital market regulation can prohibit owners and managers from trading on the basis of inside information. An effective regulatory framework that clamps down on inefficient and unfair practices like crony lending and insider trading amplifies the impact of finance on economic activity and growth.

Finally, financial regulators in low-income and lower-middle-income countries face a difficult tradeoff between promoting economic growth and safeguarding financial stability. More specifically, credit expansion allows for increased investment and faster growth, but excessive credit growth may destabilize the financial system and even precipitate a financial crisis. While regulatory authorities in all

countries face such tradeoffs, they are more pronounced in poorer countries where economic growth is a higher priority. There, authorities face a difficult balancing act between facilitating credit flows to the real economy and monitoring and preempting risks to stability. In complying with stringent international standards for bank regulation such as Basel III, these countries must be especially careful to ensure that compliance does not seriously interfere with the banking system's core function of channeling credit to the real economy.

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The Financial Systems of Financially Less Developed Asian Economies: Key Features and Reform Priorities

This paper examines the key features and reform priorities of the financial systems in Bangladesh, Cambodia, Georgia, Mongolia, and Papua New Guinea. All are low-income and lower-middle-income economies that have relatively underdeveloped systems heavily dominated by banks and with low levels of access, especially for the poor. All five countries need good governance in financial institutions and markets. They also face a difficult tradeoff between promoting economic growth and safeguarding financial stability.

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ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to the majority of the world's poor. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

